

Evolution of Value Investing: More About Value, Less About Price

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“Nowadays people know the price of everything and the value of nothing.”
-Oscar Wilde

Everybody loves a bargain. On Black Friday shoppers are carried along on a wave of momentum that overwhelms sober considerations of whether the item is really needed. Our brains are seduced by the artificial time scarcity and the ‘saving’ on an arbitrary reference point. As the behavioural economist Dan Ariely says, “Discounts are a potion for stupidity”. Likewise as investors the salience of relative prices can dominate our decisions. Price multiples are often the first port of call in the search for value. However the siren song of low prices can lead investors astray. In this article I highlight pitfalls of the ‘multiple mindset’ and offer some illustrative ideas for bridging the gap to value.

1. Unstable baseline

The comparability of a stock’s historic multiples is skewed by a plethora of changes (macro, business model, cyclical, tax and accounting etc). While investors may be aware of these issues they are easily overlooked. For example, value investors are usually reluctant to consider a stock whose multiple is above its historic average. In recent years changes have raised the level and dispersion of stock multiples. Investors looking through the prism of multiples have been slow to recalibrate what is considered ‘fair’. They use the emotive label ‘overpriced’ which suggests a sudden collapse is imminent rather than the open-ended description of a ‘low-return environment’.

2. Peer anchoring

Peer multiples are especially pernicious. Investment banks often try to highlight relative value by averaging a diverse range of unadjusted multiples. The variation in peer multiples alone should be disqualifying evidence of the utility of the exercise. Even identical peer comparisons often do more harm than good. How many points of P/E is it worth paying for better management? Multiples will not tell you the answer.

3. Bias of mean reversion

The ‘multiple mindset’ subtly conditions us to expect mean reversion. That’s helpful when things don’t change. Human nature drives the eternal ebb and flow of sentiment. We are cautioned that ‘this time it’s different’ are the most expensive words in investment. In reality the economy and markets evolve continuously. To outperform as fundamental investors we need to assess and interpret the significance of change. History ‘rhymes rather than repeats’. Precedents are a stimulus for questions rather than a playbook for answers. Why shouldn’t access to low cost diversification from passive investing raise average multiples

permanently?

4. Quest for safety

Low multiples proffer investors undue reassurance that a stock is likely to have a margin of safety. The most hazardous case is the infamous 'value trap'. The default view is that stocks on single digit multiples are 'cheap' until proven otherwise.

5. Pull of short-termism

We are attuned to multiples because the price numerator in valuation multiples changes continuously unlike the denominator. We typically pay more attention to how a 'long-term position' performs over the first week than we do subsequently. The proximity of initial price feedback to our decision makes us sensitive to 'loss aversion'.

6. Tyranny of averages

Even if cheap multiple stocks as a category outperform long-term, it does not follow that an investor should start the search for value with multiple screens. We are not buying baskets. It may be easier to eliminate 'losers' among high multiple stocks through fundamental analysis. In any case finding a stock that will benefit from multiple appreciation is less relevant as the holding period expands. Fascinating research from Professor Hendrik Bessembinder finds that the entire gain in the U.S. stock market since 1926 is attributable to the best-performing four percent of listed stocks. The fear of multiple compression deterred many potential Walmart investors over decades and the same pattern is repeating itself with Amazon. Furthermore good businesses may also pay a better return on time invested because they permit multiple points of entry over time.

7. Commoditization

If 'value investors' as a group are to outperform they must do so at the expense of another constituency. Yesterday's patsies at the table were unsophisticated retail investors and herd-following institutions. Both groups tended to chase glamour stocks and indiscriminately offload losers. Low multiples were good indicators of value. Unfortunately the mean reversion play on multiples is being commoditized as demonstrated by the poor performance of many long-short hedge funds. Quantitative funds offering variants of 'smart beta' are emerging as a new competitor. Quant models don't suffer emotional turbulence from holding pariah stocks. They can load up on traditional 'value' factors which compresses returns. Increasingly stocks on low multiples will be more likely to be genuinely higher risk. While value opportunities will periodically re-emerge in periods of turbulence the overall utility of standalone value metrics is declining.

8. Lower information content

Traditional multiples are becoming less meaningful. According to a study by Ocean Tomo intangibles assets represent 87% of S&P500 value in 2015 versus only 32% in 1985. The value of a security is revealed only retrospectively through cash flows. We are looking to be approximately right rather than precisely wrong. No matter how expensive the market seems to be, in retrospect there are always many great businesses which turn out to have been undervalued. Perhaps the entry point was not ideal, but deferring purchase is really a matter of speculating on tomorrow's price.

Buffett was a pioneer in appreciating the value of brands. The challenge for us as

contemporary 'value investors' is to enhance our tools and processes to:

- insulate our assessment of value from the contamination of price signals
- better incorporate unstructured and non-financial information
- assess the scalability and risk of intangible assets
- avoid the behavioral biases inherent in methods such as DCFs & multiples
- assess management and organisations in a more objective manner
- focus more on identifying the few long-term winners
- appreciate the impact of new financial market participants

Rather than lament high multiples we should be on the lookout for new opportunity sets. For example we cannot compete directly with quantitative funds on speed and consistency but we can selectively exploit their weaknesses. Most quantitative funds have a pricing kernel that relies on relative multiples and price action. While new money is growing the overlap in their input variables bolsters outperformance. However their methods are underpinned by methods of averaging and extrapolation from the past. As value investors we can cherry-pick where their reference class is flawed to benefit from a more nuanced understanding of mean reversion and mean divergence.

In my [Best Ideas 2018](#) presentation, "Ocado - Overpriced, Undervalued", I will discuss our investment in Ocado a stock that is heavily shorted.

The views expressed here are those of the author in a private capacity.